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CompTel®

September 5, 2002

The Honorable Michael K. Powell
Chairman
Federal Communications Commission
445 12th Street, S.W.
Washington, DC 20554

Dear Chairman Powell:

In recent weeks, several investment analysts have published reports describing the earnings pressure faced by Regional Bell Operating Companies ("RBOCs") from competitor use of the Unbundled Network Element Platform ("UNE-P").[1] CompTel finds it necessary to respond to these reports, which are based in large part on flawed assumptions,[2] because the RBOCs are using these analyses to advance their positions in several open FCC proceedings.[3] Though CompTel disagrees with many aspects of these reports, including the emphasis on UNE-P as the primary catalyst for the RBOCs' declining earnings,[4] we do agree that the Bells are facing competitive pressure in the provision of local telecommunications services for the first time. Most significant is the fact that greater UNE-P availability has forced the RBOCs to finally compete for residential and small business customers, the two customer classes which

1 *See, e.g., Wireline Services: How Much Pain from UNE-P?* UBS Warburg, August 20, 2002, and *UNE-P: The Un-Profit*, Dresdner Kleinwort Wasserstein, August 21, 2002.

2 CompTel and its members will supplement the record at a later date with a more detailed analysis of how these studies, in particular the UBS Warburg report, miscalculate the costs and revenues associated with UNE-P and long distance services.

3 *See* Ex Parte Notice from Gordon R. Evans, Vice President – Federal Affairs, Verizon, to Marlene H. Dortch, Secretary, Federal Communications Commission, August 16, 2002. (WC Docket No. 01-202, CC Docket Nos. 01-338, 96-98, 98-147) CompTel questions Verizon's decision to use per line cost and revenue data for the company that was prepared by investment analyst Anna Maria Kovacs of Commerce Capital Markets, despite the fact that Verizon's own Chief Financial Officer, Debra Toben, participated in meetings with Chairman Powell and Commissioners Abernathy, Copps and Martin that are memorialized by the ex parte notice.

4 CompTel has many concerns about the assumptions used by these reports, specifically the emphasis on UNE-P as the primary cause for the RBOCs' loss of market share and reduction in earnings. Recent investor reports released by the RBOCs' themselves ascribe earnings losses to a variety of factors, including decreasing growth in their wireless business, losses resulting from foreign investment, and so forth. Further, CompTel questions whether the RBOCs' earnings have in fact been negatively impacted to the extent described by these reports. According to SBC's July 23, 2002 Investor Briefing, "SBC's normalized wireline EBITDA margin was 42.1 percent, up 50 points from the first quarter this year and consistent with the second quarter a year ago." A telecommunications carrier with an EBITDA margin of 42.1 percent clearly is not in fiscal distress.

have been the slowest to benefit from the market-opening requirements imposed by the Telecommunications Act of 1996 ("TA-96"). Instead of creating yet another cause for concern about the financial well-being of the nation's telecommunications industry, these reports demonstrate that TA-96 and the FCC's implementing rules with regard to unbundling and pricing *are working*. In fact, these reports justify the continuation of the FCC's existing local competition rules and an immediate moratorium on the following open proceedings: broadband non-dominance (CC Docket No. 01-337), wireline broadband (CC Docket No. 02-33) and triennial review of unbundled network elements (CC Docket No. 01-338). Terminating these proceedings will create much needed regulatory stability, thereby encouraging the continued development of competition in local telecommunications markets and promoting consumer welfare.

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The threat of market share and earnings losses is a natural consequence of opening once-monopoly local telecommunications markets to competitive entry. This is because TA-96 is fundamentally based on a quid pro quo: RBOCs must open their local markets as a condition for entry into long distance markets. Thus, RBOC loss of local market share should come as no surprise. In fact, some of the interexchange carriers ("IXCs") that have become the RBOCs' most aggressive competitors in the local market, including AT&T, WorldCom and Sprint, experienced significant access line and earnings losses once the RBOCs' were allowed to enter the long distance market pursuant to Section 271 of TA-96. Rather than being a cause for concern, however, RBOC long distance entry was heralded by the FCC and state commissions as a means to enable a formidable competitor to compete head-to-head with the nation's largest IXCs, thereby creating competitive pressure that reduced retail long distance rates and encouraged carriers to offer consumer-friendly bundles of local and long distance services. Indeed, the significant competitive advantages enjoyed by the RBOCs, such as the ability to market long distance services to their near-monopoly local customer base, resulted in a precipitous decline in IXC market share once the RBOC received Section 271 authority in a state. For example, Verizon claims that it took less than seven months for its long distance affiliate to win its one millionth customer after receiving long distance authority in New York.[5] Similarly, SBC claims that as of July 2001, it had won 2.8 million long distance customers in Texas, Kansas and Oklahoma.[6] However, unlike the RBOCs, which are not accustomed to operating in a competitive environment, these IXCs did not attempt to use the transitional effects of competition as an excuse to seek government protection of their existing market share and earnings levels, nor did the government provide such safeguards. Instead, these carriers focused on growing their customer base and earnings by moving into new markets. More specifically, these carriers decided to win new local customers based on competitive merit.

Faced with real competition, the RBOCs are unveiling a list of horribles that will result if they are not able to increase UNE rates or avoid existing unbundling requirements, such as the

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5 Verizon Press Release, August 1, 2001.

6 SBC Press Release, August 20, 2001.

inability to maintain their networks.[7] Unfortunately for the RBOCs, Congress has decided that the Bells simply cannot have their cake and eat it, too. By entering the long distance market, they accepted the risk that competitors would win the RBOCs' existing local customers. The RBOCs must come to terms with the fact that they will not be able to achieve earnings based on monopoly rents in a competitive market. Competition is inevitable, so rather than fighting it, the RBOCs should embrace it.

For example, the RBOCs could staunch their earnings losses, and perhaps even become more profitable, by growing and improving their wholesale business. An RBOC loses all revenue when a competitor builds a facility, such as a loop, used to provide service to an end user customer. In contrast, providing an unbundled loop to a competitor at a TELRIC-based rate permits the RBOC to recover the forward-looking cost of that facility *plus a reasonable profit* as a matter of law. By embracing wholesale, the RBOCs could maximize the efficiency of their networks by increasing the amount of retail and wholesale traffic, thus minimizing the total loss in revenues that results when competitors build their own facilities. As a first step, the RBOCs should improve their wholesale systems and processes to facilitate competitor access to their networks. This would have the added benefit of increasing their earnings, because the RBOCs would avoid the millions of dollars in penalties assessed by the FCC and state regulators for poor wholesale performance and anticompetitive behavior. SBC alone has paid more than $66 million to the U.S. Treasury for failure to comply with the wholesale performance measures required by the SBC-Ameritech Merger Conditions; some estimates place SBC's total fines at more than $1 billion.[8]

Indeed, when faced with similar declining market share after divestiture, AT&T finally embraced wholesale once other interexchange carriers began building their own networks. It became clear to AT&T that some revenue was better than no revenue. Today, the long distance market is characterized by vibrant competition from carriers that built their own networks, use pieces of other carriers' networks in conjunction with their own facilities, or simply resell interexchange services provided by other carriers.[9] This has resulted in greater customer choice, innovative service packages and a significant decrease in retail long distance rates. According to TA-96, local customers are entitled to the same.

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7 *SBC Wants to Double its Wholesale Prices to Increase its Profits,* CHICAGO TRIBUNE, September 4, 2002. According to SBC CEO Edward Whitacre, "Our revenue is plummeting like a rock… This is leading to the ultimate ruin of this network." Of course, the FCC has acknowledged that Ameritech has had significant problems with its network infrastructure and retail service quality that predate the explosive growth in competition using UNE-P. *See* Letter from Dorothy T. Attwood, Chief, Common Carrier Bureau, to Mr. James W. Calloway, Group President - SBC Services, seeking explanations and remedies for deteriorating quality of SBC's service. (DA 00-2298, Released October 6, 2000) Competition that is facilitated by TELRIC-based wholesale rates is SBC's excuse du jour for its decision to avoid investing in its network to the benefit of its captive local customer base.

8 Press Release, *"Voices" Coalition: SBC Hits "Ignominious Milestone" of $1 Billion in Announced Penalties and Overcharges,* August 27, 2002, available at http://www.voicesforchoices.com/1091/wrapper.jsp?PID=1091-23&CID=1091-082702A.

9 In fact, the RBOCs are some of the largest non-facilities-based resellers of interexchange services.

Thus, the RBOCs' loss is the consumers' gain. Competition enabled by all modes of entry—resale, facilities deployment, and unbundled network elements—is finally providing American consumers with the benefits Congress envisioned by TA-96, including improved quality of service, innovative service offerings, and lower retail rates. For example, based on competitive pressure largely achieved through the availability of UNE-P at TELRIC-based prices, Michigan consumers recently benefited from a decrease in Ameritech's recurring charge for basic local service.[10] Ameritech also recently proposed rate reductions in Ohio.[11] These consumer welfare gains were made possible by the FCC's current local competition rules, and state commission implementation of these regulations.

In summary, FCC and state commission efforts since the passage of TA-96 are finally having their desired effect. State and federal regulators should hope that UBS Warburg's predictions materialize, so that wholesale lines will account for more than 12 percent of RBOC switched access lines by the end of 2003 and more than 17 percent by 2005. Competition means that the RBOCs stand a good chance of losing market share and earnings if they simply maintain the status quo and fail to increase efficiency or grow their business in new areas. After all, in a competitive market, the RBOCs, not government, ultimately control their profitability. The only remaining uncertainty concerns the amount of time it will take to allow every American telecommunications consumer to have a real choice among local carriers, and by extension, enjoy the consumer welfare benefits that were the ultimate goal of TA-96.

Please contact me if you would like to discuss this matter in greater detail.

Sincerely,

H. Russell Frisby, Jr.

H. Russell Frisby, Jr.
President

cc: Commissioner Kathleen Q. Abernathy
Commissioner Michael J. Copps
Commissioners Kevin J. Martin
Mr. Christopher Libertelli
Mr. Matthew Brill
Mr. Jordan Goldstein
Mr. Daniel Gonzalez
Mr. William Maher
Ms. Michelle Carey

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10 Editorial, *Competition Keeps Calling, But Local Bells Resist,* USA TODAY, July 17, 2002.

11 *Ameritech Ohio Offers New Prices for Local Residential Phone Service,* AKRON BEACON JOURNAL, August 13, 2002.